



Director of
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SITUATION REPORT

AFGHANISTAN

The situation in Herat, Afghanistan's third largest city, remains confused, but it now appears that government forces either have or soon will regain control.

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The recapture of Herat would relieve some of the immediate pressure on President Taraki and demonstrate to his opponents that the bulk of the military is still willing to follow his orders. Nevertheless, the success of Iranian-style mob tactics and the defection of a significant number of police and soldiers could well encourage similar activities in other cities. The government, moreover, still faces serious tribal insurgency in the east.

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BRIEFS AND COMMENTS

RHODESIA: Muzorewa's Plans

//Rhodesia's white political leaders and Bishop Abel Muzorewa, who is the black leader most likely to head the government of national unity after the election in April, are considering ways to cooperate to strengthen the future government. The Bishop also appears to be exploring the possibility of a broader Rhodesian settlement that would include some of the guerrillas.// [REDACTED]

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//The whites apparently want to take the lead in determining the pace the black-led government will take in dealing with racial matters. Early last month, leaders of Prime Minister Smith's Rhodesian Front Party presented Muzorewa with a document calling for greater cooperation between their parties, the gradual elimination of racially based parties, and the eventual deletion of clauses in the new constitution most objectionable to blacks.// [REDACTED]

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//Muzorewa was impressed that such an initiative was made well before the election and, in return, decided that his party would not attempt to recruit whites to contest the Rhodesian Front for the white seats in Parliament. The Bishop realizes he will need white support for his government and wants to meet again soon with Rhodesian Front leaders to discuss possible ministerial appointments, to plan future government policies, and to map a joint strategy for obtaining international recognition for the new government.// [REDACTED]

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//Muzorewa may believe that the emergence of a black-led government in Rhodesia will open up new possibilities for a settlement with the guerrillas. He has been trying for several months to meet with Zimbabwe African National Union leader Robert Mugabe to discuss a possible alliance. Mugabe has rejected these approaches, but several senior officials have indicated that ZANU would not rule out talks at some future date.// [REDACTED]

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ITALY: New Three-Party Coalition

The formation of a three-party coalition by Prime Minister Andreotti yesterday is not likely to prevent an early parliamentary election in Italy.

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The coalition, which will be sworn in by President Pertini today, consists of Andreotti's Christian Democrats, the Social Democrats, and the Republicans. The three parties do not have a parliamentary majority, however, and will not be able to gain the requisite vote of confidence, given the opposition of the Communists and the near certainty that the Socialists will follow the Communist lead. Pertini will have little choice but to dissolve parliament and schedule an election; Andreotti is going through the motions, however, to ensure that he is in charge as a caretaker during the politically delicate period leading up to an election.

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Andreotti is not expected to present the government to parliament until 29 March, and the confidence vote may not be held until after the Communist Party's congress, which is slated to run from 30 March to 3 April. This timetable continues to suggest that the national election will be held in early June, probably concurrent with the direct elections to the European Parliament on 10 June.

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The internal harmony of the Christian Democratic Party was clearly Andreotti's primary consideration in parceling out cabinet posts. Although he made veteran Republican leader La Malfa his deputy prime minister and budget minister, Andreotti retained Christian Democratic incumbents in all of the other key posts, including Foreign Affairs, Defense, Interior, Treasury, and Finance. The other portfolios, divided between the Social Democrats and Republicans, were taken mainly from "technician" ministers or from Christian Democrats with little political influence.

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ETHIOPIA: Communist Aid Relationship

//A little more than a year after the USSR actively switched its support from Somalia to Ethiopia, the Soviet-Ethiopian relationship is dominated by Moscow's military assistance program. Soviet economic assistance is small in comparison, and we see little evidence that economic aid will be increased significantly in the near term, even though Moscow is now studying projects for possible implementation in the future.//

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//Moscow delivered \$1 billion in military equipment to Ethiopia in 1978--the second largest Soviet arms delivery ever made to a Third World country in a single year.

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//We strongly suspect that new military agreements were struck during the latter half of the year to reinforce Ethiopia's across-the-board transition from Western to Soviet military weaponry and tactics. We expect that the follow-up supply pattern will resemble those associated with some of Moscow's Middle East clients--a steady, substantial inflow of equipment, more technical training, and future additions of more sophisticated hardware.//

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//Moscow signed a new economic and technical assistance agreement last September, but we have no evidence that specific projects have been funded despite reports of commitments ranging up to \$3 billion. Until now, Moscow has failed to initiate major new aid projects and refused to comply with Ethiopia's request for a steel mill and other heavy industrial projects. East European countries, however, responded to Ethiopia's requests for assistance with \$300 million of new commitments while China, formerly Ethiopia's most active Communist donor, let its aid program slip because of Ethiopia's Soviet-inspired attacks on Chinese Third World policies.//

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INTERNATIONAL: Effects of Oil Price Hike

Disruption of Iranian oil exports and the resulting sharp upward pressure on world oil prices is causing speculation about another major recession in the near future. Because the major foreign industrial countries are now at a stronger point in the business cycle than they were just prior to the 1973-1974 oil price rise, price increases over the next year will not as easily push them into recession and double-digit inflation.

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In late 1973, the "big six" foreign industrial countries--Japan, West Germany, France, the UK, Italy, and Canada--were posting sluggish economic gains across the board, and inflation had already moved into the double-digit range. These nations' economies are now at a different point in the business cycle. Real economic activity has been quickening and inflation slowing, inventories are not overbuilt, and most current accounts in the balance of payments are in surplus.

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The impact of fiscal stimulation packages enacted last year will buoy demand in some key countries. Greater consumer savings afford some cushion in the event of an oil price-induced decline in real incomes. Moreover, declines in inventories need not be as drastic and fixed business investment does not have as far to fall as in 1973 and 1974. Lower underlying inflation rates and higher unemployment may temper restrictive government measures; high unemployment is now a political issue in several major countries.

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USSR-US: Chemical Warfare Negotiations

//Growing impatience with the lack of progress at US-Soviet chemical warfare negotiations is making other members of the 40-nation Committee on Disarmament at Geneva more anxious to play an active role in the preparation of a chemical weapons treaty.//

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The Soviets opened the current round of bilateral talks last month with a long statement about China's invasion of Vietnam and its alleged use of chemical warfare there, which they used to justify their insistence that China ratify the prospective treaty. The issue of mandatory on-site inspection of destruction of stockpiles and facilities, which the Soviets have rejected for a variety of reasons, continues to be a stumbling block.

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//Most Western and nonaligned members of the Committee on Disarmament believe they should play a role in the negotiations because any resulting convention would affect all nations. Italy has formally proposed the creation of an ad hoc working group to negotiate a chemical weapons convention. France, Sweden, and Canada have recently supported the idea, and many other states have proposed various ways of increasing the Committee's role.

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The Soviets' strong opposition to an expanded negotiating group on chemical warfare and the Committee's rule of consensus would prevent one from being established. The interested nations might agree instead on a group that would examine a specific technical problem, such as methods of measuring toxicity or destroying chemical weapons stocks.

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CHINA: Communications Satellites

//China is negotiating the purchase of an advanced communications satellite system with West German and US firms and is also continuing work on its own communications satellite to be ready for launch in 1980 or 1981. We believe the early launch date may be unrealistic.//

//No contracts have been signed, but the Chinese recently signed agreements with the West German and US Governments on long-term cooperation in space technology.

//China apparently will use foreign communications satellites for educational television and other mass communications. By using advanced technology and high power direct broadcast satellites, much smaller and cheaper antennas can be used at ground stations. Because the Chinese could require thousands of such stations, the savings over a system requiring larger antennas could be significant.//

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JORDAN - SAUDI ARABIA: Hussein Visit

//Jordan's King Hussein arrives in Saudi Arabia today for two days of talks with King Khalid and presumably with Crown Prince Fahd and Foreign Minister Prince Saud. The Saudi and Jordanian leaders probably hope to compare notes on the recent visit by Dr. Brzezinski and to coordinate their strategy before the Arab League meeting to impose sanctions on Egypt that is expected to follow the signing of the Egyptian-Israeli peace treaty.

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FRANCE-CHAD: Withdrawal of Troops

France announced yesterday that it will gradually withdraw its military forces from Chad now that a peace accord has been signed by competing Chadian factions. The French probably will continue to play at least a military advisory role, however, if invited to do so by the government that emerges from the current political chaos. Most of the more than 2,500 French soldiers now in Chad were sent there early last year when the French halted a major Libyan-backed rebel threat against the government. The large French presence was a major factor in preserving the military stalemate that lasted until early this year. During the most recent factional fighting, French troops fought only when directly attacked and concentrated their efforts on protecting European nationals.

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USSR: First Session of New Supreme Soviet

The first session of the newly elected Supreme Soviet is scheduled to open on 18 April. No agenda has been announced, but the first session of a new assembly receives the formal resignation of the government's Council of Ministers and confirms its new membership--normally a routine procedure involving few or no changes in the Council. The party Central Committee plenum that is expected to precede the Supreme Soviet session, however, probably will appoint someone to the key post of party secretary for supervision of defense-industrial production, a position vacated by Yakov Ryabov, the newly appointed First Deputy Chairman of the State Planning Committee. The appointment will give some indication of how seriously the sidetracking of Ryabov has hurt the political fortunes of his patron, party Secretary Andrey Kirilenko, who has been widely considered next in line to President Brezhnev in the party hierarchy.

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IRAN: Banking in a Bind

[REDACTED]

Although Iran's banking system remains operable, several of the largest banks are in financial danger. Revolutionary and worker committees have attempted to take over or influence policy in a number of banks, including the central bank. Local and international banking transactions are proceeding on a limited scale; rumors of nationalization--denied by the government--are inhibiting a return to more normal operation. To get the crippled economy functioning again, the government will have to assist the banks rapidly to restore banking services, especially commercial credit.

[REDACTED]

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In the months following the first civil disturbances, Iranians developed such a high demand for cash that the banks were continually drained of rials. General chaos in the business sector delayed payments due the banks. The central bank tried to relieve the cash shortage of the commercial banks but was itself often closed by strikes, which also limited the government's ability to issue the needed new cash. Given the traditional preference of most Iranians to hold cash, the banks will find it doubly difficult to attract deposits. Bank Melli, the largest commercial bank, reportedly is the only healthy bank left. As an agent for the central bank, it has had some access to foreign exchange throughout most of the upheaval.

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Extensive physical damage to the banks is delaying the resumption of fuller operations. Bankers, however, apparently had learned from earlier riot experiences to keep dual records and had strengthened their safes before the worst of the demonstrations. More ominous than the physical destruction and the loss of some records is the huge backlog of payments, collections, and recordkeeping that most banks face after the several months of curtailed activity. This includes a backlog of arrearages in foreign trade payments estimated at more than \$3 billion. Recent reports indicate that domestic check clearing resumed around 10 March.

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//The Iranian banking system is being hurt by legal attachments of its overseas deposits to settle outstanding loans, unfulfilled contracts, letters of credit, and other obligations. If this movement snowballs, the legal tangles could tie up Iran's international banking transactions and commerce for many months to come.//

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Aside from financial tangles and losses of records, bankers themselves are undergoing a crisis of confidence. Reports of widespread arrests of bankers and other businessmen and the seizure of bank records--in preparation for the prosecution of "corrupt capitalists and their allies"--and rumors of bank nationalization are undermining the system. Until the fate of the arrested businessmen is clear and the government clarifies its plans for the banking system, the numerous expatriate Iranian managers and entrepreneurs in Western Europe and the US are unlikely to return home. In any event, the prospect of operating the banks according to unelucidated Islamic tenets may not appeal to many bankers. If fees are substituted for interest, however, as in other Islamic countries, the change may not be so disturbing.

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Government Action Critical

The government faces the difficult task of providing credit to the banking system--and through it to the economy--without spurring inflation, which has already soared to high but unquantifiable levels. Given its liquidity problems, the banking system will need additional authorization to expand credit, which the central bank governor has pledged to provide. Possible support could include government-supported loans to the commercial banks, increasing the number and kind of discountable instruments, and a further reduction of reserve requirements. This process of furnishing adequate credit will require continued resort to the printing press. While the restoration of banking services will initially help to dampen inflation by increasing the supply of goods, the accompanying credit expansion will potentially increase inflationary pressure.

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In addition to providing credit, the government may have to declare a holiday on legal action against the banks to give them time to sort out their liabilities. Further down the line, recapitalization and consolidation of banks will likely be necessary. [REDACTED]

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The economy has managed to sustain itself for more than four months with the banks in considerable chaos. The bazaar moneylenders normally provide about 15 percent of total credit and undoubtedly have been supplying a greater share in recent months. The bazaar operators also have been conducting foreign currency trading out of cars during strike periods. Much of the economy operates on a cash basis, with funds from under mattresses and from company safes. [REDACTED]

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Internationally, Iran is unlikely to receive either long-term or medium-term commercial financing any time soon. The international banking sector probably will want at least a six-month track record of oil exports and political stability before abandoning its conservative stance on Iran. Short-term credit relations with established correspondents and customers will probably be rolled over; any substantial increase in exposure is unlikely. The 78 representative offices of foreign banks now in Iran will be allowed to stay, according to Dr. Ali Movlavi, the new governor of the central bank, although they will be more closely supervised than before. [REDACTED]

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The rial may be allowed to float freely, according to Movlavi. The exchange system to be used is now under study; officials have discussed the possibility of a split exchange rate. A de facto devaluation will help Iran's non-oil exports and government rial revenue. At the same time, it will raise the price of imported food, raw materials, and capital goods. [REDACTED]

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